

## **Defining PPPs in Brazil – 23Jul03**

*By Greg Haddock, PwC, director infrastructure, government & utilities group, PricewaterhouseCoopers, São Paulo, Brazil*

Brazil was floored by its dramatic political and financial crisis of 2002. The country has a new government and the economic scenario has improved, but enormous infrastructure needs are going unmet. The private sector wants definition of projects and policy. Is that definition on the way?

### **Crisis and recovery**

The financial crisis of 2002 started with the launch of the presidential election campaign in April. The markets feared a victory for left-wing candidate Luiz Inácio Lula de Silva (Lula), leader of the Workers' Party (Partido dos Trabalhadores - PT). From around 2.35 to the dollar in April, the real devalued to 4.00 by August and Brazil's risk premium soared to 2,400 basis points. The IMF granted a US\$30bn loan package in an effort to halt the devaluation and prevent the country following Argentina into bankruptcy.

Lula went on to win in October and to take power on 1st January 2003. His is the first left-wing government in Brazil's history, an event of enormous political and emotional significance. The chaos which was dreaded has not materialised. The government has maintained, even exceeded the conditions of the IMF loan: reform programmes of the pension and tax systems have been drafted and submitted to Congress; a current account surplus of 4.25% has been maintained and the inflationary pressures brought about by the devaluation choked off with the world's highest base rates - currently 26%. As a result the real has strengthened and settled at around 2.8 to the dollar, Brazil's risk premium has recovered to around 800bp (comparable to Turkey) and the central bank is predicting that annual inflation for 2003 will come in at 10.2%, tolerably above the target of 8.5%. The economy is expected to grow 1.5% during the year.

There is huge pent up demand for infrastructure in all sectors. The paralysis of the public sector during the election campaigns (which were held at both federal and state levels) and the economic crisis meant that virtually no projects were tendered during 2002, and there has been very little activity during the first half of 2003 as the new governments get to grips with their budgets and plan their investment strategies. However, the federal government and many states are now confronting serious questions about the country's inadequate infrastructure and looking at how to facilitate projects by satisfying investors' concerns about public sector risk, exchange rate volatility and legal and regulatory frameworks, with a view to providing concrete dealflow from the beginning of 2004.

### **Plano Pluri-Annual 2003-07**

Brazil has three levels of administration - the Union or federal government, the 26 states plus the federal district of Brasilia, and the municipalities. The federal government is responsible for infrastructure of national importance while the states and municipalities take care of local requirements. In the roads sector, for example, the federal government plans and executes inter-state roads while state governments manage intra-state networks.

Both federal and state governments are currently preparing Planos Pluri-Anuais (PPAs), investment plans for the period 2004-07. The overall aims of the federal PPA, being prepared by the Ministry of Planning, are to reduce inequality and social exclusion, generate growth and employment, improve export capacity and develop economically disadvantaged regions. The Ministry has identified railways, roads, water, urban transport and housing as priorities for infrastructure investment.

The federal and state PPAs will be submitted to their relevant legislatures by the end of August, to be approved by the end of the year. They will provide the definition of project opportunities which the private sector needs and will create the administrative conditions for projects to be structured and tendered.

The federal government is actively committed to private-public partnerships as part of the solution to the country's investment needs. Lula held an audience with representatives of a number of Brazil's major corporates at the end of May to hear their views and requirements. The Ministry of Planning is working on the

development of an infrastructure guarantee fund (see below) to meet private sector concerns about public sector risk.

At state level, the picture is somewhat mixed. In the southern state of Paraná, for example, the government has been actively hostile to private sector participation: since taking power in January, governor Roberto Requião has taken over by decree the operation of state water company Sanepar, a joint venture between the state and a consortium of Vivendi, Banco Opportunity, Andrade Gutierrez and Copel; suspended the process of environmental licensing of around 20 small hydroelectric concessions, of which 4 had already started construction; and announced his intention to submit a law to the state assembly to take the state's six road concessions back into public ownership. At the other end of spectrum are Minas Gerais and São Paulo: Minas Gerais has already submitted draft laws to its state assembly (on 8th July) to create a clear legal framework for public-private partnerships and a PPP fund to participate in financing and guarantee long-term state government obligations. São Paulo is studying what changes it needs to make to its legislation. Both states are planning projects to be tendered as PPPs within their PPAs.

## **Transport**

The Ministry of Transport aims to overcome the deficiencies and imbalances of Brazil's transport system and improve its export capacity: road journeys account for 96% of inter-urban and 62% of cargo journeys<sup>1</sup>. The rail sector has been neglected and is concentrated in the southern half of the country, offering few north-south options. Products from the interior have to be transported long distances by road. Transport costs are high as a result and a hindrance to Brazil's international competitiveness - the cost of transporting cargo 1,500km from origin to loading at port in Brazil is US\$28 per tonne versus US\$18 in the United States<sup>2</sup>. The Ministry of Transport has therefore stated that its priorities are:

- Recuperation and extension of the national railway network;
- Improvement of internal waterways;
- Improvement of the federally-owned ports of Santos, Sepetiba, Rio Grande, Suape and Pecém;
- Recuperation of the federal road network.

Practically the whole of Brazil's 30,000km rail network was put out to concession between 1996-98 - only the Ferrovia Norte-Sul, a 2,200km US\$1.6bn federal project to link agricultural areas of the interior to the coast, of which 215km have been completed, remains in federal hands. The government company responsible for the project is currently seeking private sector investors to participate in the project. Other projects necessary to improve export capacity lie with concessionaires - for example, the Transnordestina (north-eastern Brazil) and Ferronorte (south-east) projects, freight lines designed to improve transport options for agricultural producers. A number of concessionaires are behind in their investment commitments on existing lines, prejudicing cargo services. The Rail Revitalisation Plan, announced by the Ministry of Transport in May, aims to stimulate increased private investment by reviewing the regulatory framework, and to reorganise concessions so as to permit government expenditure alongside private investment. The Ministry is aiming to bring forward over US\$450m in investment as a result of these changes over the next year. A major new project, being planned as a concession by the federal government and the state government of São Paulo, is Ferroanel, a freight railway designed to divert cargo transport out of the centre of the city of São Paulo with US\$360m investment required up to 2006.

The roads sector was also a source of opportunities during the late 1990s, when 40 concessions (7 federal, 32 state and 1 municipal) were awarded. The Ministry of Transport is reviewing the terms of tenders for seven new federal concessions, suspended in 2002 because of administrative reorganisation. These include routes between São Paulo and Belo Horizonte and between São Paulo and the southern commercial centres of Curitiba and Florianópolis. Real tolls are likely to be preferred. However, the possibility exists for state contributions to be made to investments and for performance-based or shadow toll type structures. Individual states will also consider their own road programmes, and concessions are likely to be tendered in Minas Gerais and São Paulo in addition to other states.

Through BNDES the federal government is also working with the Corporación Andina de Fomento, Inter-American Development Bank and Fonplata on the development of transport projects aimed at improving regional integration (part of the IIRSA3 programme). The projects involving Brazil will be presented at a conference to be held by BNDES in August.

## **Water, urban transport and housing**

Especially important in the battle to improve living conditions and reduce social exclusion, these sectors have been given special emphasis under the Ministry of Cities, a creation of the new government with the role of minister given to Olívio Dutra, a long-time colleague of Lula. Fifteen million Brazilians have no access to piped water, 60m have no waste water services, and of the waste water which is collected, 75% is disposed of without treatment; urban transport inefficiencies create intolerable journey times in many cities and aggravate the exclusion of neighbourhoods from economic activity; 6-7m Brazilians are estimated to live in favelas, the country's infamous shanty towns. Since responsibility for these sectors lies at state/municipal level, projects will be fed into the state PPAs. The Ministry of Cities is guiding states to look at how the sectors need to be reorganised and regulated in order to improve efficiency and attract investment. Policies are to be presented and debated at the Conference of Cities, an event to be coordinated by the Ministry of Cities in late October and intended to provoke and support reform at state level. The policy of the federal government in these sectors is therefore to place responsibility clearly with the states, but assist them to make decisions which will facilitate increased investment and improved regulation.

In the water sector, the majority of Brazilians are served by state water companies. These operate on the basis of concessions from the municipalities, but in reality in many cities there is no contract and no formal regulation. The previous government attempted to regularise this situation by setting up a national regulatory agency, but this was perceived as a threat to the security of employment of the state water companies' public sector employees and the reform did not pass in Congress. While recognising that the problem of regulation must be solved, the federal government also considers that the solutions need to be found at state level and has therefore mandated municipalities, state governments and the state water companies themselves to develop policies on regulation, to be presented at the Conference of the Cities and then approved at state level. What is the possible result of this process? - in some states, programmes of projects, possibly in the form of sub-concessions offered by the state water companies, defined in the PPAs and tendered alongside the creation of regulatory agencies; in others, continuing murk. There also exists the possibility of further concessions being awarded to private sector operators by the minority of municipalities which lie outside the ambit of the state water companies - more than 40 were awarded in the late 1990s. However, these will be in smaller cities, outside the metropolitan regions.

In urban transport, Brazil's history of private sector participation to date has been difficult. Concessions awarded to construct and operate new metro lines in Rio de Janeiro (Lines 3 and 4) and Salvador have encountered problems with state contributions to construction costs. In São Paulo, the Line 4 metro concession has been ten years in the making - the public sector will finance construction of the line and a number of stations, a concessionaire will operate the line and provide the rolling stock, signaling and construction of a second phase of stations, a model adopted to reduce the amount of financing to be raised by the private sector, although it will raise complicated inter-face and timing issues. Total project cost is estimated at US\$1.1bn, of which US\$418m has already been offered from the World Bank and the Japan Bank for International Cooperation. The construction contracts were awarded in June and planning of the concession is due to start shortly. Tenders for the concession contract can reasonably be expected in first half 2004.

Metro/light rail projects are also in various stages of planning in the cities of Porto Alegre, Goiânia, Brasília, Fortaleza and Natal. In Rio de Janeiro, the state government is planning to tender Line 6 of the metro as a concession. The project is being promoted as important for the city's infrastructure requirements when it hosts the Pan-American Games in 2007. As an aside, Rio de Janeiro is a candidate for the 2012 Olympic Games, a major impulse to the improvement of its transport and other infrastructure.

## **Energy**

This was a sector which produced many opportunities for foreign investors in the late 1990s as a number of generation concessions were tendered, most of the distribution companies which serve states and/or urban areas were privatised and transmission line concessions were granted. However, the new government has described the policies of its predecessor as lacking long-term vision and being responsible for the volatility in production which has seen Brazil go from power shortage in 2001 to surplus at present with shortage forecast again for 2007; the sector is lop-sided, with 80% of generating capacity still in public hands and only 20% of distribution; the privatisation of the distribution companies was hasty and responsible for the heavy indebtedness which has led many into financial crisis, with a total of US\$1.4bn unmet payment obligations accumulated to date (a

situation exacerbated by the devaluation of 2002); the regulatory agency Aneel has been criticised as inconsistent and confusing to investors in its actions. And for all its efforts, the last government left 13m Brazilians still without electricity.

Since the beginning of the year the Ministry of Mines and Energy has been working on a new model for the sector, to be published during the third quarter. Its stated objectives will be to promote and facilitate long-term planning, create safer returns for both public and private investors and extend supply. Its desired effect is the resumption of project tenders. It has been framed on the assumption that the current mixture of public and private generators and distributors will continue. The following orientations have been given:

- The country's 64 distributors will have to produce 5 year demand plans; on the basis of these plans, they will sign power-purchase agreements with generators participating in an energy pool, with the Ministry taking a coordinating role; existing supply contracts will be examined and renegotiated during a transition period;
- The energy pool will combine relatively cheap electricity produced by public sector generation companies and the relatively expensive power of private generators and produce a median price for distributors; it will be used by distributors to purchase power for on-sale to captive consumers; free consumers (eg large industrial consumers) will be able to purchase power from independent producers;
- New hydroelectric concessions will be tendered as necessary to satisfy projected demand according to the 5-year plans; these concessions could be large - in a recent speech, Luiz Pingelli Rosa, president of Eletrobrás, the biggest of the state-owned generation companies, spoke of the need for US\$4-5bn of investment, with the participation of the private sector (although the growth projections on which these figures are based will be scrutinised); new concessions will be awarded on the basis of lowest tariff offered;
- The government will set up a hedge fund to protect businesses against the impact of possible future devaluations.

The status of Aneel is as yet unclear, with a question mark over whether the government sees it continuing its current role in policy formulation.

Once released, the Ministry's model will be submitted to a period of debate with industry players before being sent to Congress for approval, subsequently to be implemented, probably from first quarter 2004. It remains to be seen whether this programme is achievable and whether investors can expect clarity and a programme of opportunities next year.

## **Social Sectors**

PPPs in social sectors such as prisons, hospitals and schools, structured on the basis of performance payments by the public sector, are being considered throughout the country. Prisons are a state-level responsibility. Nationally there is a deficit of approximately 62,000 formal prison places, with the situation particularly difficult in São Paulo, where 18,000 prisoners are held in police stations at any one time. The São Paulo state government is considering PPPs as a solution to this dilemma. New school facilities will be required to raise the level of education provision to 15-17 year olds from its current level of 84.5% plus new hospitals, particularly in economically disadvantaged areas. All social projects will also be included in the state and federal PPAs.

## **Legal framework, risk and financing**

The Brazilian legal framework does not clearly provide for projects in which the public sector makes long-term payments for services to a private sector operator - the existing Concession Law only provides for the operator to be remunerated via tariff revenue. To complement the existing Concession Law, both the federal government and the states of Minas Gerais and São Paulo are considering specific PPP Laws - in Minas Gerais a draft has already been presented to the state assembly and a draft federal law will be presented to Congress along with the PPA at the end of August.

The federal government and those state governments looking most seriously at the viability of PPPs are aware that the concept of projects reliant in full or in part on long-term payment streams from the Brazilian public sector is adventurous in a sub-investment grade country, and are addressing the issue of public sector risk. At the end of June, Guido Mantega announced the government's intention to create an infrastructure investment

fund, backed by the assets and shares of public sector companies and enjoying a multilateral guarantee, possibly from the Inter-American Development Bank. The concept is that the fund may be used to guarantee long-term public sector obligations and to issue debentures in the markets to be applied to the financing of projects. The framework which Minas Gerais is putting in place also includes a PPP Fund, also based on the idea of using state-owned assets and shares as collateral for public sector obligations. Another legal issue will have to be addressed, however - how increased public sector spending/obligations will fit in with the Law of Fiscal Responsibility, a law passed by the previous government which limits the ability of public sector entities to incur financial liabilities. Whilst generally seen as an essential part of Brazil's process of constructing a more stable financial and political environment, the law is now being questioned as too restrictive given the country's infrastructure needs.

In the past private sector developers have found funding from the Inter-American Development Bank and IFC in dollars and the national development bank BNDES in reais (plus, to a lesser extent, Caixa Econômica Federal, the federal development bank which acts in the water and housing sectors). This basic profile will remain unchanged. However, if successful in their implementation, the guarantee funds being mentioned should have the effect of widening the availability of commercial funds in reais. The local commercial market has always been averse to Brazilian public sector risk and, as long as base rates are at 26%, there is little incentive to diversify. Without reductions in base rates (the Central Bank of Brazil is forecasting base rates of 21.93% by the end of 2003 and 16.8% by the end of 2004), well-structured projects and good regulatory structures, guarantee funds alone however will not encourage local banks and investors into projects.

### **Summary**

The next weeks and months will see a number of key events:

Publication of the PPA in August 2003 and subsequent debate by Congress; debate of the federal PPP law and of the Minas Gerais initiatives;

- Publication of the new energy model by the Ministry of Mines and Energy and subsequent debate;
- Conference of the Cities in late October and publication of new state-level strategies in the water, urban transport and housing sectors.

- end -

### *Footnotes*

1 Source – Ministry of Transport

2 Source - Associação Brasileira das Indústrias de Óleos Vegetais

3 Iniciativa para la Integración de la Infra-estructura Regional Suramericana

4 Source: Instituto Nacional de Estudos e Pesquisas Educacionais, figure from 1999